

(c) As used in this section, the term “preceding four quarters” means the last day of the quarter just ended (or the date for which the minimum capital report is filed, if different), and the three preceding quarter-ends.

#### APPENDIX A TO SUBPART A OF PART 1750—MINIMUM CAPITAL COMPONENTS FOR INTEREST RATE AND FOREIGN EXCHANGE RATE CONTRACTS

1. The minimum capital components for interest rate and foreign exchange rate contracts are computed on the basis of the credit equivalent amounts of such contracts. Credit equivalent amounts are computed for each of the following off-balance sheet interest rate and foreign exchange rate contracts:

##### *a. Interest Rate Contracts*

- i. Single currency interest rate swaps.
- ii. Basis swaps.
- iii. Forward rate agreements.
- iv. Interest rate options purchased (including caps, collars, and floors purchased).
- v. Any other instrument that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

##### *b. Foreign Exchange Rate Contracts*

- i. Cross-currency interest rate swaps.
- ii. Forward foreign exchange rate contracts.
- iii. Currency options purchased.
- iv. Any other instrument that gives rise to similar credit risks.

2. Foreign exchange rate contracts with an original maturity of 14 calendar days or less and foreign exchange rate contracts traded on exchanges that require daily payment of variation margins are excluded from the minimum capital requirement computation. Over-the-counter options purchased, however, are included and treated in the same way as the other interest rate and foreign exchange rate contracts.

##### *3. Calculation of Credit Equivalent Amounts*

a. The minimum capital components for interest rate and foreign exchange rate contracts are computed on the basis of the credit equivalent amounts of such contracts. The credit equivalent amount of an off-balance sheet interest rate and foreign exchange rate contract that is not subject to a qualifying bilateral netting contract in accordance with this appendix A is equal to the sum of the current exposure (sometimes referred to as the replacement cost) of the contract and an estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then

the current exposure is the mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in United States dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. The effective rather than the apparent or stated notional amount must be used in this calculation. The credit conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Foreign exchange rate contracts (percent)
1 year or less .....	0.0	1.0
Over 1 year .....	0.5	5.0

d. Because foreign exchange rate contracts involve an exchange of principal upon maturity, and foreign exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign exchange rate contracts than for interest rate contracts.

e. No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indexes, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

##### *4. Avoidance of Double Counting*

In certain cases, credit exposures arising from the interest rate and foreign exchange instruments covered by this appendix A may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy, counterparty credit exposures arising from the types of instruments covered by this appendix A may need to be excluded from balance sheet assets in calculating the minimum capital requirement.

##### *5. Collateral*

a. The sufficiency of collateral for off-balance sheet items is determined by the market value of the collateral in relation to the credit equivalent amount. Collateral held against a netting contract is not recognized for minimum capital standard purposes unless it is legally available to support the single legal obligation created by the netting contract. Excess collateral held against one contract or a group of contracts for which a recognized netting agreement exists may not be considered.

b. The only forms of collateral that are formally recognized by the minimum capital standard framework are cash on deposit; securities issued or guaranteed by the central governments of the OECD-based group of countries, United States Government agencies, or United States Government-sponsored agencies; and securities issued by multilateral lending institutions or regional development banks.

#### 6. Netting

a. For purposes of this appendix A, netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of interest rate and foreign exchange rate contracts is recognized for purposes of calculating the credit equivalent amount provided that the following criteria are met:

i. Netting must be accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the Enterprise would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances.

ii. The Enterprise must obtain a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the Enterprise's exposure to be such a net amount under—

A. The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

B. The law that governs the individual contracts covered by the netting contract; and

C. The law that governs the netting contract.

iii. The Enterprise must establish and maintain procedures to ensure that the legal characteristics of netting contracts are kept under review in the event of possible changes in relevant law.

iv. The Enterprise must maintain in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.<sup>1</sup>

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, the Enterprise represents that it has met the requirements of this appendix A and all the appropriate documents are in the Enterprise's files and available for inspection by OFHEO. OFHEO may determine that an Enterprise's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in this appendix A. If such a determination is made, the netting contract may be disqualified from recognition for minimum capital standard purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of interest rate and foreign exchange rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding the current exposure of the netting contract and the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with paragraph 3 of this appendix A. Offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure. Therefore, for purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange rate contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-market values is zero or negative, then the current exposure of the netting contract is zero. OFHEO may determine that a netting contract qualifies for minimum capital standard netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should

<sup>1</sup> A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.

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be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the minimum capital requirement computation—for example, foreign exchange rate contracts with an original maturity of 14 calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an Enterprise may elect consistently either to include or exclude all mark-to-market values of such contracts when determining net current exposure.

### Subpart B—Risk-Based Capital

SOURCE: 66 FR 47806, Sept. 13, 2001, unless otherwise noted.

#### § 1750.10 General.

The regulation contained in this subpart B establishes the methodology for computing the risk-based capital level for each Enterprise. The board of directors of each Enterprise is responsible for ensuring that the Enterprise maintains total capital at a level that is sufficient to ensure the continued financial viability of the Enterprise and is equal to or exceeds the risk-based capital level computed pursuant to this subpart B.

#### § 1750.11 Definitions.

Except where a term is explicitly defined differently in this subpart, all terms defined at § 1750.2 of subpart A of this part shall have the same meanings for purposes of this subpart. For purposes of subpart B of this part, the following definitions shall apply:

(a) *Benchmark loss experience* means the rates of default and severity for mortgage loans that—

(1) Were originated during a period of two or more consecutive calendar years in contiguous areas that together contain at least five percent of the population of the United States, and

(2) Experienced the highest loss rate for any period of such duration in comparison with the loans originated in any other contiguous areas that together contain at least five percent of the population of the United States.

(b) *Constant maturity Treasury yield* means the constant maturity Treasury yield, published by the Board of Governors of the Federal Reserve System.

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(c) *Contiguous areas* means all the areas within a state or a group of two or more states sharing common borders. “Sharing common borders” does not mean meeting at a single point. Colorado, for example, is contiguous with New Mexico, but not with Arizona.

(d) *Credit risk* means the risk of financial loss to an Enterprise from non-performance by borrowers or other obligors on instruments in which an Enterprise has a financial interest, or as to which the Enterprise has a financial obligation.

(e) *Default rate* of a given group of loans means the ratio of the aggregate original principal balance of the defaulted loans in the group to the aggregate original principal balance of all loans in the group.

(f) *Defaulted loan* means a loan that, within ten years following its origination:

- (1) Resulted in pre-foreclosure sale,
- (2) Completed foreclosure,
- (3) Resulted in the acquisition of real estate collateral, or
- (4) Otherwise resulted in a credit loss to an Enterprise.

(g) *Financing costs* of property acquired through foreclosure means the product of:

(1) The number of years (including fractions) of the period from the completion of foreclosure through disposition of the property,

(2) The average of the Enterprises’ short-term funding rates, and

(3) The unpaid principal balance at the time of foreclosure.

(h) *Interest rate risk* means the risk of financial loss due to the sensitivity of earnings and net worth of an Enterprise to changes in interest rates.

(i) *Loss* on a defaulted loan means:

(1) With respect to a loan in category 1, 2, or 3 of the definition of defaulted loan the difference between:

(i) The sum of the principal and interest owed when the borrower lost title to the property securing the mortgage; financing costs through the date of property disposition; and cash expenses incurred during the foreclosure process, the holding period for real estate collateral acquired as a result of default, and the property liquidation process; and